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# In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 305

A. J. WHIPPLE AND MILDRED WHIPPLE, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT*

## BRIEF FOR THE RESPONDENT

### OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 24–34) are not officially reported. The opinion of the court of appeals (R. 133–134) is reported at 301 F. 2d 108.

### JURISDICTION

The judgment of the court of appeals (R. 144) was entered on April 4, 1962. A petition for rehearing (R. 144–147) was filed on April 24, 1962, and denied (R. 148) on May 11, 1962. The petition for a writ of certiorari was filed on August 7, 1962, and granted (R. 151, 371 U.S. 875) on October 22, 1962. The jurisdiction of this Court rests on 28 U.S.C., Section 1254(1).

## QUESTIONS PRESENTED

1. Whether taxpayer's activities in organizing, financing, and managing the Mission Orange Bottling Company of Lubbock, Inc., a corporation of which he owned 80% of the stock, constituted—either in themselves or in conjunction with similar activities on behalf of other distinct corporate enterprises—a "trade or business" within the meaning of Section 23(k) (1) and (4) of the 1939 Code, so that his loss from the nonrepayment of loans to the bottling corporation was fully deductible as a "business" bad debt.

2. Whether the loss from the nonrepayment of the taxpayer's loans to the bottling corporation was proximately related to any of his alleged businesses of leasing real property, marketing soft drinks, or lending money, or to any of these in combination.

## STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.[1]
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (k) [as amended by Sec. 124(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Bad Debts.*—
>
> (1) *General rule.*—Debts which become worthless within the taxable year; * * *. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection. * * *

[1] Section 166 (a) and (d) of the 1954 Code is to the same effect.

* * * * *

(4) *Non-business debts.*—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

Treasury Regulations 118 (1939 Code):

SEC. 39.23(k)–6. *Nonbusiness bad debts.* (a) * * * The question whether a debt is one the loss from the worthlessness of which is incurred in the taxpayer's trade or business is a question of fact in each particular case. The determination of this question is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by section 23(e) is "incurred in trade or business" under section 23(e)(1).

(b) The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the recipient, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one

in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a nonbusiness debt for the purposes of this section.

* * * * *

## STATEMENT

A. J. Whipple ("taxpayer") and Mildred Whipple[2] are husband and wife and reside in Houston, Texas (R. 25).

1. In April 1951, taxpayer purchased the assets of the Mission Orange Bottling Company, a sole proprietorship owned by one D. C. Casey; rented (as lessee), for a period of 20 months, the premises occupied by Casey's business; and obtained a franchise from the Mission Dry Corporation entitling him to produce, bottle, distribute, and sell Mission beverages in certain counties in Texas. He conducted the business as a sole proprietorship until approximately July 1, 1951. On that date, in order to avoid personal liability in connection with the beverage he was selling to the public, taxpayer transferred the bottling machinery and equipment to Mission Orange Bottling Company of Lubbock, Inc. (hereafter called "Mission Orange"), a corporation he had organized a month earlier. Taxpayer retained the bottling franchise in his own name (R. 27).

Mission Orange was incorporated on June 8, 1951, with an authorized capital stock of $20,000, and issued

[2] Mildred Whipple is joined herein as petitioner because she filed a joint income tax return with her husband for the year 1953. The transactions involved, however, were conducted solely by the taxpayer, A. J. Whipple.

and outstanding stock of $10,000, of which $8,800 was owned by taxpayer (R. 27). The charter of the corporation was amended on December 8, 1952, to increase the authorized and outstanding stock to $40,000, and thereafter the holdings were as follows:

| *Shareholder* | *Shares* | *Percent* | *Par Value* |
|---|---|---|---|
| Taxpayer | 308 | 77. | $30,800 |
| James A. Finley | 10 | 2.5 | 1,000 |
| Charles Dillingham | 2 | .5 | 200 |
| Cecil Clark | 20 | 5. | 2,000 |
| Dora B. Ellzey | 10 | 2.5 | 1,000 |
| D. M. Dozier | 10 | 2.5 | 1,000 |
| Jack Knostman | 20 | 5. | 2,000 |
| James F. Webster | 20 | 5. | 2,000 |
| Total | 400 | 100 | $40,000 |

Prior to the end of 1953, taxpayer increased his holding to 318 shares, giving him an equity of $31,800, or 79.5% of the total outstanding stock (R. 28).

Early in 1952, taxpayer constructed a bottling plant on land which he had purchased in Lubbock, Texas. The land was acquired at a cost of $4,589.75, and the plant building constructed at a cost of $39,011.95, for a combined cost of $43,601.70 (R. 28, 44). On July 14, 1952, he leased the plant to Mission Orange for a ten-year term, beginning August 1, 1952, with an option to renew. The prescribed rental was $500 per month over the life of the lease plus one percent of the gross sales of the corporation commencing in the fourth year. In his 1952 and 1953 tax returns, taxpayer claimed a deduction for depreciation of the bottling plant in Lubbock, but reported no rental income from that building in either year (R. 28).

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Throughout the period involved here, taxpayer was president of the corporation, made important policy decisions, and prescribed the business practices to be followed (R. 57, 117–119). During much of 1953 he also performed the function of plant manager (R. 119). His tax returns for the years 1951 through 1953, however, reflect that he received no salary from the corporation.

In purchasing the bottling assets of taxpayer's sole proprietorship, Mission Orange recorded an account payable to him in the amount of $25,502.50 (R. 28). Taxpayer (directly or indirectly) made cash advances to the corporation of $48,550.70 in 1952 and $6,750 in 1953, or a total of $55,300. He also paid expenses of the corporation amounting to $2,975.76 in the years 1951 through 1953, and received refunds and credits of $4,388.50. Thus, the balance due taxpayer on December 1, 1953, was $79,489.76 (R. 28). On December 15, 1953, taxpayer advanced Mission Orange $48,000 to discharge its obligations to trade creditors (R. 28). On the same date he received a transfer from the corporation of all its bottling equipment, machinery, and an automobile, crediting the corporation with their aggregate book value of $70,414.66 (R. 28). On December 31, 1953, the net amount owed to taxpayer by Mission Orange was $56,975.10.

On September 1, 1951, taxpayer acquired 76% of the stock of a corporation known as Mason Root Beer, a soft drink distributing company which bottled root beer in the Lubbock plant and distributed it, pursuant to a franchise, in Amarillo, Texas. Mason Root Beer failed in 1953, and taxpayer's return for that year reflected a $3,300 loss on his stock in that corporation and a non-business debt loss of $53.33 (R. 28, 112–113).

Taxpayer also had a vending-machine arrangement with Ideal, Indiana, which sold vending machines to the trade. Mission Orange had no interest in this venture (R. 28, 114).

2. During the period in question, and for many years previously, taxpayer engaged in a variety of economic activities, chiefly in the construction and real estate fields. Prior to 1941, he was a construction superintendent and an estimator for a lumber company. In 1941, and for approximately one year thereafter, he and an associate were partners in the construction of houses (R. 25). Beginning in 1942, taxpayer helped to form a number of partnerships engaged in various aspects of the construction and building supply businesses (R. 25). In 1949 and 1950, he organized or helped to organize seven corporations, of which six were construction, lumber, or road-building enterprises, and the seventh a real es-

tate rental company which owned and rented the premises occupied by two of taxpayer's other concerns (R. 25–26). In 1951, taxpayer sold his interest in all of these ventures to his partner, Miles Strickland, along with his equity in five other corporations in the rental housing or construction businesses. All of these sales resulted in gain to the taxpayer, which he reported as long-term capital gain in his 1951 income tax return (R. 26).

In 1951, taxpayer purchased improved land in Houston, Texas, to serve as the location for various construction businesses and other enterprises, and also formed a partnership—the A. J. Whipple Construction Company—with three associates (R. 26). During 1951 and 1952, taxpayer was an original incorporator of eight corporations, all but one of which were engaged in various aspects of the construction and real estate development businesses (R. 26). The one exception was Mission Orange.

During the period 1951–1953, the taxpayer acquired land in Pasadena, Angleton, Bellaire, and Houston, Texas, and engaged in sales activities in connection with those properties; purchased, operated, and later sold a restaurant in Houston (R. 26, 95, 104–105); and engaged in several oil ventures (R. 26, 65). Throughout this three-year period, taxpayer made loans to his various corporations, partnerships, fellow shareholders, and partners, some but not all of which yielded him interest. His income tax returns for

1951, 1952, and 1953 reflected the following interest income (R. 29):

| *Payor* | *1951* | *1952* | *1953* |
|---|---|---|---|
| Whipple Lumber Co., Inc. | $19.35 | $868.51 | $1,047.38 |
| Dozier-Whipple Construction Corp. | 61.42 | 393.89 | ---------- |
| Whipple Construction Co., Inc. | 130.68 | 5.61 | ---------- |
| Angleton Homes Corp. | 331.98 | ---------- | ---------- |
| A. J. Whipple Construction Co. | 4.92 | 44.28 | ---------- |
| Cecil Clark | 70.56 | 45.61 | ---------- |
| D. M. Dozier | 70.56 | 45.61 | ---------- |
| G. A. Durham | 86.98 | 74.33 | ---------- |
| J. A. Finley | 64.46 | ---------- | ---------- |
| Whipple Equipment Co., Inc. | 591.89 | 575.51 | 37.82 |
| Willard Evans | 70.56 | 45.61 | ---------- |
| Dora Eilzey | 70.56 | 45.61 | ---------- |
| L. R. Olive | 24.99 | 4.76 | ---------- |
| Durham-Clark Building Supply Co. | 9.24 | 57.95 | ---------- |
| W. N. Atkins | 20.81 | *(20.81) | ---------- |
| Roy J. Pafe | 1.19 | *(1.19) | ---------- |
| Harland Miller | ---------- | 47.00 | ---------- |
| The Brag Club, Inc. | ---------- | 53.07 | 19.16 |
| Guy Francis-Guy's Restaurant | ---------- | ---------- | 643.23 |
| Total Interest Income | **$1,680.15 | $2,285.35 | $1,747.59 |

*Interest accrued and upaid in 1951.

**The correct total is $1,690.15.

Taxpayer received salaries totalling $29,400 in 1952 and $33,450 in 1953 from some of the construction companies (R. 26).

3. In his 1953 income tax return taxpayer claimed $56,975.10, the amount due him from Mission Orange,

as a business bad-debt deduction (R. 28, 29). The Commissioner determined that this item was a non-business bad debt within the meaning of Section 23(k) of the Internal Revenue Code of 1939 and, on that basis, asserted a deficiency. This determination was affirmed by the Tax Court, which found or concluded, among other things, that taxpayer was not in 1953 in the business of organizing, promoting, managing or financing corporations; of lending money; or, as an individual, of bottling soft drinks (R. 29, 32–33). The Tax Court's decision was affirmed by the court of appeals (R. 133–143).

## ARGUMENT

### TAXPAYER'S LOSSES FROM THE BAD DEBTS OWED BY MISSION ORANGE WERE NOT INCURRED IN A TRADE OR BUSINESS

#### INTRODUCTION AND SUMMARY OF ARGUMENT

The principal issue in this case is whether a taxpayer who organizes, manages, and finances a number of corporations, but seeks no financial rewards from these activities other than the benefits which inure to him as a stockholder, can properly claim that he as an individual is in a "business" separate and distinct from the businesses of the corporations. The question is significant because of the distinction which is drawn in Section 23(k) of the 1939 Code (Section 166 of the 1954 Code) between "non-business" bad debts, which are treated as short-term capital losses (*i.e.*, can be offset only against capital gains, plus ordinary income to the extent of $1,000) and other bad debts, which are deductible from ordinary income. Section

23(k)(4) defines a "non-business debt" as—

> a debt . . . other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The applicable regulation (Treasury Regulations 118 (1939 Code) Section 39.23(k)-6), adopting the language of the committee reports on Section 23(k)(4),[3] requires the relation between the conduct of the trade or business and the loss from the bad debt to be "proximate." To qualify a debt for an ordinary deduction, therefore, the taxpayer must establish (1) that he is engaged in a business, and (2) that the bad-debt loss was proximately related to that business. But when a stockholder sustains a bad-debt loss in connection with a loan to his corporation and seeks to deduct it as a loss incurred in his own trade or business, he encounters the well-established principle that a corporation has a personality separate from that of its stockholders and that *its* business is not *their* business. To escape the impact of this rule, it has become common for taxpayers in that situation to claim as an independent "business," apart from that of a corporation, certain auxiliary activities they perform for the corporation's benefit—*e.g.*, organizing, financing, managing—and to deduct the losses as business bad debts because incurred in connection with that alleged independent business. An irreconcilable conflict has developed among the circuits as to whether

[3] H. Rep. No. 2333, 77th Cong., 2d Sess. 77 (1942-2 Cum. Bull. 372, 431); S. Rep. No. 1631, 77th Cong., 2d Sess. 90 (1942-2 Cum. Bull. 504, 573).

such activities, though their sole purpose is to protect or benefit the taxpayer's investment as a stockholder, nonetheless constitute a "trade or business."[4]

[4] The decision below is solidly supported by *Holiz* v. *Commissioner*, 256 F. 2d 865 (C.A. 9); *Wheeler* v. *Commissioner*, 241 F. 2d 883 (C.A. 2); *Towers* v. *Commissioner*, 247 F. 2d 233 (C.A. 2); *Commissioner* v. *Smith*, 203 F. 2d 310 (C.A. 2), certiorari denied, 346 U.S. 816.

The decisions irreconcilable with the decision below are *Washburn* v. *Commissioner*, 51 F. 2d 949 (C.A. 8); *Foss* v. *Commissioner*, 75 F. 2d 326 (C.A. 1); *Campbell* v. *Commissioner*, 11 T.C. 510; *Sage* v. *Commissioner*, 15 T.C. 299; *Alexander* v. *Commissioner*, 34 T.C. 758; *Macy* v. *Commissioner*, decided January 18, 1949 (1949 P-H T.C. Memorandum Decisions, par. 49,009; *Maytag* v. *United States*, 289 F. 2d 647 (C. Cls.).

Other decisions upon which taxpayer relies are distinguishable. Two cases cited involved alleged businesses having no connection with "organizing, financing and managing" corporations. For instance, in *Maloney* v. *Spencer*, 172 F. 2d 638 (C.A. 9), the court found the taxpayer in the business of leasing real property, which we do not deny can be a business; and the only real issue was the factual question whether the loans were proximately related to the taxpayer's activities in leasing property to his corporations, or to his stockholder interests in those corporations. See *infra*, pp. 40–45. Also, in *Trent* v. *Commissioner*, 291 F. 2d 669 (C.A. 2), the issue was whether a loan made to a corporation by a salaried employee, as a condition to his continued employment, was proximately related to his business of being an employee.

In *Mays* v. *Commissioner*, 272 F. 2d 788 (C.A. 6), the court held that where the taxpayer sets up and uses corporations as a part of a separate, individual business of his own, bad debt losses incurred in so doing are deductible as a business bad debt. We do not quarrel with this principle of law (see fn. 13, *infra*, p. 31), but we believe the fact situation there failed to conform to the requirements of that test.

In *Commissioner* v. *Stokes' Estate*, 200 F. 2d 637 (C.A. 3),

We submit that the court below correctly held that losses sustained by such stockholders from the corporation's failure to repay loans are not incurred in any independent "trade or business" of the stockholder, however active he may be in the corporation's business in an effort to enhance the value of his investment.

In developing our argument we deal first with a preliminary point—Judge Hutcheson's suggestion that section 23(k)(4) allows a full deduction for all bad debts resulting from a transaction for profit—and show that the argument is not only inconsistent with binding precedents but unsound in principle.

We go on to show that a stockholder's receipt of income and capital gains from the ownership of stock in a corporation is not a trade or business, because the corporation's business is not the stockholder's business and the mere receipt of income and capital gains is not a trade or business. For the stockholder to show that he took an active part in promoting and managing the corporation's trade or business adds nothing to his case if his sole return is from his investment in the corporation's business. Moreover, the taxpayer's activities directed solely to enhancing the value and earning capacity of his stock investments do not take on the character of a "trade or business"

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the relation between the corporation and the taxpayer's activities is not clear, and we take no position as to its significance.

merely because he forms and manages several corporations, rather than one.

Finally, we demonstrate the lack of merit in taxpayer's alternative contentions—*i.e.*, that he was engaged in, and incurred the bad-debt loss in the course of one or more of the following separate businesses: (a) lending money; (b) bottling and selling soft drinks; or (c) leasing real property. The Tax Court properly found that the few, relatively small, interest payments received by the taxpayer in the years in question did not warrant the conclusion that he was in the money-lending business, and that even if he had been, there was no evidence that the advances to Mission Orange—which were neither secured nor evidenced in writing, and which provided neither for repayment of principal nor for payment of interest—were made as part of that lending business. The Tax Court further found—again with ample justification—that the taxpayer was not engaged, as an individual, in the "trade or business" of bottling and selling soft drinks at the time the debt in question became worthless. Finally, even if it be conceded that constructing the bottling plant and leasing it to Mission Orange constituted a "trade or business," there is no showing that the bad-debt loss was proximately related to that business. On the contrary, the record shows that the primary, if not the sole, purpose of making the loans was to protect the taxpayer's investment as stockholder, and that his interest as lessor, if it played any part at all in motivating the advances, was entirely secondary.

A. PROOF THAT A BAD DEBT RESULTED FROM A TRANSACTION FOR PROFIT IS NOT SUFFICIENT TO SHOW THAT THE LOSS WAS "INCURRED IN THE TAXPAYER'S TRADE OR BUSINESS"

In the opening pages of his brief (pp. 24–25) the taxpayer seems to imply that the provision for limited deductibility of non-business bad debts (section 23(k)(4) of the 1939 Code) was intended to cover only loans to friends and relatives, made without thought of profit and without expectation of repayment. The same construction appears to have been adopted by Judge Hutcheson in his dissenting opinion below (R. 138–143). Under this view, the entire range of profit-seeking activity would be comprehended within the statutory category of "trade or business." We submit that this interpretation has already been rejected by this Court and, moreover, has no merit as an original matter.

Judge Hutcheson's interpretation was based upon a comment in the House committee report (H. Rep. No. 2333, *supra* at 408) citing personal loans as an "example" of the abuses intended to be curbed by the proposed amendment. He appears to have construed this language to mean that this was the full intended scope of the measure. In *Putnam* v. *Commissioner*, 352 U.S. 82, 90–92, however, this Court rejected without ado a similar contention, saying (p. 91, fn. 17):

> Petitioners argue that this was its sole purpose and that the section should be construed as limited in application to such loans. The context of the segment of the House Ways and Means Committee Report discussing this ob-

jective does not support the petitioners' argument.

And, by way of explanation, the Court set out the same language from the committee report quoted by the taxpayer (Br. 24) and by Judge Hutcheson (R. 140, fn. 2) but with the words "an example" (which precede the reference to loans to a friend or relative) underscored.

Taxpayer's contention, moreover, is fundamentally at odds with both the statutory scheme and the legislative history of Section 23(k)(4). The terminology of the Internal Revenue Code consistently differentiates the broad range of human activities undertaken for profit from the much narrower included category of a "trade or business." Thus, Section 23(e) of the 1939 Code (Section 165(c) of the 1954 Code) allowed a deduction for losses: (1) if incurred in trade or business; and (2) if incurred in any transaction entered into for profit, though not connected with a trade or business. Similarly, Section 23(a) of the 1939 Code (Sections 162(a) and 212 of the 1954 Code) distinguished between (1) trade or business expenses—*i.e.*, all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business; and (2) non-trade or non-business expenses—*i.e.*, all the ordinary and necessary expenses paid or incurred for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. And, Section 23(l) (Section 167(a) of the 1954 Code) allowed a deduction for depreciation (1) of property used in the trade or business;

and (2) of property held for the production of income. The apposition makes it plain that "trade or business," in these provisions, does not include all transactions for profit.

When Congress used the term "trade or business" in Section 23(k)(4), it presumably intended that term to have the same limited scope it had in the other subdivisions of Section 23 just mentioned. That inference is expressly confirmed by the legislative history of Section 23(k)(4). Prior to 1942, any bad debt loss, regardless of its business or non-business character, was deductible in full from ordinary income. The effect of Section 23(k), which was added to the Code by Section 124 of the Revenue Act of 1942 (56 Stat. 798), was to limit the deductibility of all such losses other than those sustained in the taxpayer's "trade or business." The purpose of the amendment was explained by this Court in *Putnam* v. *Commissioner, supra,* 352 U.S. at 90–92.

> The objectives sought to be achieved by the Congress in providing short-term capital loss treatment for nonbusiness bad debts are also persuasive that section 23(k)(4) applies to a guarantor's nonbusiness debt losses. The section was part of the comprehensive tax program enacted by the Revenue Act of 1942 to increase the national revenue to further the prosecution of the great war in which we were then engaged. It was *also* a means for minimizing the revenue losses attributable to the fraudulent practices of taxpayers who made to relatives and friends gifts disguised as loans. *Equally,* however, the plan was suited to put nonbusiness invest-

> ments in the form of loans on a footing with other nonbusiness investments. * * * We may consider Putnam's case in the light of these revealed purposes. His venture into the publishing field was an investment apart from his law practice. The loss he sustained when his stock became worthless as well as the losses from the worthlessness of the loans he made directly to the corporation would receive capital loss treatment; the 1939 Code so provides as to nonbusiness losses both from worthless stock investments and from loans to a corporation, whether or not the loans are evidenced by a security. * * * [Emphasis added.]

In discussing Section 124, the committee reports state that the determination whether a debt is incurred in a trade or business "is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by section 23(e) is 'incurred in trade or business' under paragraph (1) of that section."[5] Section 23(e), in turn, draws a distinction between losses which are incurred in "trade or business" (paragraph (1)) and losses which are incurred "in any transaction entered into for profit, though not connected with the trade or business" (paragraph (2)). It is plain, therefore, that the category of "non-business" bad debts was intended to include not only personal loans but also loans made in connection with activities which, though profit-seeking, do not constitute a "trade or business" in the technical sense.

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[5] H. Rep. No. 2333, 77th Cong., 2d Sess. 76–77 (1942–2 Cum. Bull. 372, 431); S. Rep. No. 1631, 77th Cong., 2d Sess. 90 (1942–2 Cum. Bull. 504, 573).

The limited scope of the trade-or-business concept is further demonstrated by the legislative history of Section 23(a), which deals, as we have noted, with the deduction of business and non-business expenses. In *Higgins* v. *Commissioner*, 312 U.S. 212, this Court held that the handling and oversight of the taxpayer's extensive stock and bond investments, even though it involved continuous personal activity on the taxpayer's part, as well as the full time operation of an office and staff, did not constitute a "trade or business" for purposes of the business expense deduction. In response to *Higgins*, and as part of the same 1942 legislation which added Section 23(k) to the Code, Congress adopted Section 23(a)(2), authorizing, for the first time, the deduction of "non-trade" or "non-business" expenses, *i.e.*, those incurred in the "production or collection of income, or for the management, conservation, or maintenance of property held for the production of income." See *United States* v. *Gilmore*, No. 21, decided February 18, 1963. It is significant that in making such expenses deductible, Congress did not see fit to broaden the existing concept of trade or business, which had been restrictively interpreted in *Higgins* and which continued to be an important concept for other purposes, but instead created a new category of income-producing activity. Indeed, the committee reports underscore the lack of any intent to alter the trade-or-business concept by pointing out that the amendment would allow deductions "whether or not such expenses are paid or incurred in carrying

on a trade or business."[8] It can scarcely be doubted that when the same Congress, in the same legislation, used the same term—"trade or business"—to define the test of eligibility for business bad-debt treatment, it meant that term to have the same limited meaning it had under the expense-deduction section. And, conversely, it intended that "non-business" bad debts should include income-producing activities of the type covered by the non-business expenses provision.

B. ORGANIZING, FINANCING AND MANAGING ONE OR MORE CORPORATIONS IS NOT A SEPARATE "TRADE OR BUSINESS" IF THE TAXPAYER'S ONLY RETURN IS THE INCREASED VALUE AND EARNING CAPACITY OF HIS CORPORATE INVESTMENT

*1. Investing in the stock of a corporation is not a trade or business*

The vital distinction between a "trade or business" and other activities which, though not incident to a "trade or business," are nonetheless undertaken for the purpose of profit results in a basic differentiation between "business" activities and "investment" activities. A "trade or business" has been usefully defined by members of this Court as activity which "involves holding one's self out to others as engaged in the selling of goods or services." *Deputy* v. *DuPont*, 308 U.S. 488, 499 (concurring opinion of Justices Frankfurter and Reed.) While there may be room for debate as to whether the element of "holding out" is essential to the concept of business, there can be no doubt as to the essentiality of "selling of goods or services." Broadly conceived, the category of "trade or business" may embrace such diverse enterprises as

[8] S. Rep. No. 1631, *supra* p. 87; H. Rep. No. 2333, *supra*, p. 74, 1942-2 Cum. Bull. 370, 429.

the sale of services by a lawyer or an employee, the sale of a novel, a cartoon, or even an idea; or the "sale" of money at interest. The point we emphasize is that the element of "sale" is an indispensable feature of all of these transactions and the means by which profit is realized.

It is well settled therefore, that the investment of funds in the stock of a corporation or corporations, with a view to deriving gain in the form of dividends and capital appreciation, is not a "trade or business." *Higgins* v. *Commissioner*, *supra*. That rule is expressly conceded by the taxpayer here and by many of the decisions upon which he relies. *E.g.*, *Maytag* v. *United States*, *supra*, at 650; *Commissioner* v. *Stokes' Estate*, *supra*, at 638; *Foss* v. *Commissioner*, *supra*, at 328; *Sage* v. *Commissioner*, *supra*, at 304.

It is equally well-settled that the business of a corporation is not the business of its stockholders for tax purposes. In *Dalton* v. *Bowers*, 287 U.S. 404, and *Burnet* v. *Clark*, 287 U.S. 410, this Court held that when a taxpayer chooses to operate his enterprise through the medium of a corporation, he cannot claim the corporation's business as his own. To the same effect see *Deputy* v. *DuPont*, 308 U.S. 488, 494; *Noland* v. *Commissioner*, 269 F. 2d 108 (C.A. 4); *Skarda* v. *Commissioner*, 250 F. 2d 429 (C.A. 10); *Commissioner* v. *Schaefer*, 240 F. 2d 381, 383 (C.A. 2). This point also is acknowledged here.

From the foregoing propositions it follows that a taxpayer seeking to establish the right to a deduction for a business bad debt on account of a corporation's

failure to repay a loan must show that the loss was incurred in his, the taxpayer's, trade or business. It is not enough that the loan was made to enhance the value and productivity of his stock, and thus to yield a profit. Nor is it enough that the taxpayer was engaged in furthering the corporation's business. To qualify he must prove that the loss was proximately related to a business of his own.

Petitioner seeks to carry this burden by arguing that his activity in organizing, managing, and financing several corporations, of which he was major stockholder and controlling figure, constituted such a business. There is no dispute as to the nature of his activity. Taxpayer was interested primarily in construction, real estate, and related enterprises, occasionally diverging into other fields such as the soft drink operation involved here. Although in earlier years he had conducted these enterprises as partnerships, by 1949 he had begun to operate, for the most part, through the medium of corporations, organizing a new entity for each project and becoming its principal stockholder. His relationship to Mission Orange was typical; he organized it, owned 80% of its stock, occasionally advanced it funds, was its principal officer, and participated extensively in the management of its affairs. Taxpayer contends that these activities were conducted with the frequency, regularity and continuity which, in his view, are the sole criteria of a business.

In support of his position, taxpayer relies upon a series of lower court cases[7] which draw a decisive distinction between the so-called "passive investor," who merely holds stock and cashes dividend checks, and the entrepreneur who organizes and takes an active part in managing several corporations. To the former, these cases would deny business bad-debt treatment; to the latter, they accord it.

We now show that taxpayer's view is unsound and that the cases which support his position should be overruled (see fn. 4, *supra*, p. 12).

*2. The contribution of services to a corporation for the purpose of promoting its business and thereby enhancing the value of the taxpayer's investment in its stock is not a trade or business*

Organizing, financing and managing one or more corporations does not constitute a "trade or business" of a taxpayer-stockholder if he engages in these activities without compensation, looking for his reward solely to an increase in the value of his corporation's stock. This is the central proposition upon which our case rests. The proposition follows inescapably, we think, from the meaning of "trade or business," which does not include all undertakings for profit, and from the basic distinction between the corporation and its shareholders.

A "trade or business", as we have shown, is a series of more or less regular, loosely grouped transactions

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[7] *E.g., Maytag* v. *United States, supra; Commissioner* v. *Stokes' Estate, supra; Foss* v. *Commissioner, supra; Sage* v. *Commissioner, supra.*

in which the owner of the trade or business exchanges goods or services for some *quid pro quo* in the hope of gain or profit. The element of gain or profit is indispensable, but not all gainful or profitable activity is a trade or business. The element of frequency and regularity is also probably essential, but it too is not enough. There must be present, before there is a trade or business, the additional element of sale or exchange; and the gain or profit must come in the sale or exchange. One who regularly organizes, manages or finances corporations in return for a fee is engaged in a trade or business. And he is so engaged even though he works for only one corporation and receives a salary. In either event the element of a sale or exchange, with its *quid pro quo,* is present. But if the taxpayer renders services in organizing, promoting or managing a corporate business, without receiving any form of consideration, solely for the purpose of building up the corporation's business and thereby profiting as one of its shareholders, he is not engaging in a business of his own and gains a return only as an investor.

This central proposition is established by the classic decisions of this Court in *Dalton* v. *Bowers,* 287 U.S. 404, and *Burnet* v. *Clark,* 287 U.S. 410. Both cases arose under similar provisions in the revenue acts[8] permitting a taxpayer to carry net losses over into a subsequent taxable year as a deduction if the losses resulted from, or were attributable to, "the operation

[8] *Dalton* arose under Section 206(a) of the Revenue Act of 1924, 43 Stat. 253, 260; *Burnet* under Section 204(a) of the Revenue Act of 1921, 42 Stat. 227, 231.

of a trade or business regularly carried on by the taxpayer." In *Dalton*, the taxpayer, an active researcher and inventor, had organized six corporations for the purpose of developing, improving, manufacturing and selling his inventions. He was the sole owner, controller, and manager of each company. When one of these enterprises—to which he had advanced large sums of money—became insolvent, the taxpayer claimed as a loss, attributable to the operation of his own "trade or business", the entire amount he had invested in the then worthless stock of the corporation. He took the position that he, individually, was engaged in the comprehensive enterprise of exploiting his inventions, and that the corporation was merely an instrumentality of that business. Pointing out that the taxpayer was not regularly engaged in the business of buying and selling corporate stocks (but had organized the corporation and taken over its shares with the ultimate intention of selling them at a profit, *i.e.*, presumably, capital gain) and that he had treated the corporation as a separate entity for tax and other purposes, the Court upheld the decision of the court of appeals that the loss was incurred in connection with the taxpayer's investment in the corporation, and not in the operation of a trade or business.

In *Clark*, the taxpayer was the majority stockholder, president, and active head of a dredging company, to which he devoted all of his time and energies. He had also been active in the dredging field through several partnerships which frequently acted in asso-

ciation with the corporation. When the company became insolvent, the taxpayer suffered the loss of his stock investment, and also of amounts paid by him pursuant to his endorsements of the corporation's notes. He claimed the right to a loss carry-over with respect to both types of losses. The court of appeals held for the taxpayer, emphasizing, in a passage quoted by this Court (p. 414), that he was regularly engaged in the dredging business through a corporation to which he devoted his full time and energies and that, while taxpayer admittedly did not regularly carry on the businesses of endorsing notes for profit or selling corporate stocks, his transactions of those types in the record were an integral aspect of the regular course of his dredging business. This Court reversed. It stressed that the business which Clark carried on for the corporation was not his own business; that he had regularly treated the corporation as a separate entity for tax purposes; that he was not regularly engaged in endorsing notes, or buying and selling corporate securities; and that the endorsements were occasional transactions intended to preserve the value of his investment in the capital shares. Although the Court spoke of the endorsements as "occasional transactions," it used the phrase only to point out that Clark was not a money-lender regularly in the business of endorsing notes for profit (just as the taxpayer here was not in the business of lending money for profit).

Thus, the *Dalton* and *Clark* decisions squarely hold that a taxpayer who devotes his time to the business of a corporation, or to the businesses of several corporations, and receives his financial return only as a stock-

holder, is not engaged in an independent trade or business of his own; the business of the corporation is not his business and the obtaining of money as an investor is not a trade or business.

The holding is confirmed by common sense. Suppose, for example, that the sole proprietor of a retail grocery store forms a corporation through which to carry on his enterprise, but continues to direct its affairs on a full time basis and to advance it needed operating funds. Concededly, such a person would no longer, as an individual, be engaged in the grocery business. To be sure, if he received a salary for his services he would then be engaged in the business of being a corporate employee. See *Trent* v. *Commissioner*, 291 F. 2d 669 (C.A. 2); *infra*, pp. 30, 34–35. But, in the absence of compensation, it would border on absurdity to say that the taxpayer, though not engaged in the grocery business, was engaged in the business of managing a corporation engaged in the grocery business. In short, if the present taxpayer's activities are confined to a single corporation, then no matter how extensive and continuous these activities may be; they would not, under *Dalton* and *Clark*, constitute a separate business of "organizing, managing, and financing." Indeed, we are aware of no decision holding that such activities, when undertaken with respect to a single corporation, and with the sole purpose of enhancing the taxpayer's interest as stockholder of that corporation qualify as a "trade or business."

The distinction between such activities and the true "trade or business" of organizing, promoting and managing corporations is clarified by contrasting petition-

er's activities with those of persons who are truly in the "business" of being promoters, organizers or managers of corporations. The true promoter obtains compensation in return for his services in one of two ways:

(i) He may, as a consistent practice, set up corporations with a view to holding them for sale or resale as soon as they achieve going-concern status. In such a case, the corporations would constitute the inventory or stock-in-trade of his individual business of "dealing in corporations," and the proceeds of the sales would have to be reported as ordinary income. In *Giblin* v. *Commissioner*, 227 F. 2d 692, the Fifth Circuit (per Judge Tuttle, who also wrote the court's opinion in the instant case) held that such trafficking in corporations constituted a separate business of the taxpayer.[9]

(ii) He may organize corporations for others in return for a fee or commission. In that case, he becomes a professional "promoter" in the classic sense of that term, the corporate promoter of whom Professor Ballantine wrote the following description:[10]

> The primary function of the promoter is to find an enterprise and interest investors in financing a proposed corporation to take it over. He is the projector who originates the

[9] Whether the facts of *Giblin*—or, for that matter, of any of the decided cases—actually fit that description may, of course, be doubted. The possibility is, indeed, probably more theoretical than real, since the taxpayer who maintains an "inventory" of "corporations" for sale is more readily imagined than found.

[10] *Ballantine on Corporations* 102 (Rev. ed. 1946).

> enterprise of which a corporation is the usual machinery. He is the pre-incorporation developer and manager of the business which the proposed corporation will undertake. The typical promoter,—the promoter in the fullest sense, performs various services in launching an enterprise and may employ experts, lawyers, bankers, solicitors and other persons to aid him. The various activities of the promoter may be classified as follows: (1) the discovery and investigation of a promising business opportunity; (2) the formulation of business and financial plans; (3) assembling the enterprise by negotiations and obtaining some control over the subject matter by options or contracts made on behalf of the proposed corporation or on his own credit; (4) the making of arrangements for financing the enterprise and the flotation of securities; (5) last but not least, he must arrange tactful and painless methods for *getting his own reward for the task of promotion out of the prospective investors* and for reimbursement for his expenses, contracts, and services without frightening away those who are expected to provide the funds. He is thus practically in the position of a seller of the enterprise to the prospective investors, seeking a speculative profit for himself and his associates on the investment of others, very often taken in the form of securities. [Emphasis added.]

The fact that a promoter will often accept all or part of his fee in the form of stock, rather than cash,[11] does

[11] But note that I Dewing, *Financial Policy of Corporations* (5th ed.), p. 416, fn. m, says that "The professional promoter

not alter the nature of his indivdual business as a promoter. It means simply that he has converted his fee into an investment in the corporation, the investment thereafter becoming a separate venture having nothing to do with his promotional business. Whether he receives his fee in the form of cash or stock, he must report it in the year of receipt as ordinary compensation income. If stock is received, it must be treated as the equivalent of cash and reported in the amount of its then fair market value.[12]

In the same way, one might be in the business of "managing" corporations if, instead of being merely an employee of one or more corporations (albeit the managing officer), he were to hold out his services in that capacity as an independent contractor, receiving a fee from his corporate clients. An example might be a hotel management firm which, as an independent contractor, undertook for a prescribed fee the management of a chain of hotels owned by another entity. Indeed, we concede that even a corporate employee, rendering services in return for a salary, would be in a "trade or business." *Trent v. Commissioner*, 291 F. 2d 669 (C.A. 2). And, of course, the specific reward for the service of "financing" corporations would be the receipt of interest or some sort of finder's bonus. The point is, however, that in every case, the services must be given as part of an exchange transaction from which the

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[that is, one who engages in this function as his business] is usually reluctant to accept stock as compensation."

[12] Treasury Regulations on Income Tax (1954 Code), Section 1.61-2.

taxpayer receives a *quid pro quo*.[13] If this element of compensation or *quid pro quo* is removed, then whatever else they may be, the activities do not constitute a business. In such a case, the taxpayer's services to the corporations (or the interest value of the funds he supplies interest-free)[14] constitute simply

[13] Another situation in which business-bad-debt treatment might be warranted arises where the taxpayer sets up a corporation as an instrumentality for carrying out some aspect of his individual business or to protect its operation and earning capacity. An illustration is furnished by *Dorminey* v. *Commissioner*, 26 T.C. 940, in which the taxpayer, who was individually engaged in the produce-selling business, advanced funds to a corporation he had helped organize for the purpose of insuring his produce business a continuing supply of bananas. The losses incurred when the resulting debts became unrecoverable were allowed business-bad-debt treatment because they constituted, in effect, part of the cost of acquiring the goods to be sold by taxpayer's individual produce enterprise. The differences between that situation and the one here are quite obvious: first, the taxpayer in *Dorminey* was undeniably involved in an enterprise which provided its own source of income, separate from that of the corporation; secondly, the purpose of setting up the corporation and lending it money was not to make it a profitable investment to the taxpayer as stockholder (though, presumably, he was not indifferent to the prospect) but, primarily, to make it a dependable supplier of bananas for his produce business. In all bad debt cases in which the taxpayer has a dual stake in the stability of the corporation, so that his interest as stockholder and his interest as seller or buyer go hand in hand, there will, of course, be difficulties of proof as to which interest is uppermost in motivating the loan, see *infra*, pp. 40–45. Whether the taxpayer here may properly claim to be engaged in a separate business in his role as lessor or soft drink entrepreneur is a question we take up *infra*, pp. 48–52.

[14] The question whether the instant advances to Mission Orange constituted a contribution to capital or a true debt is not presented to this Court, since the Commissioner stipulated in the Tax Court that the sole issue with respect to the sums involved here is whether they constitute a business bad debt or a non-business bad debt.

a contribution to capital (which, if the taxpayer is not himself the stockholder, would also be a gift).

Suppose that in the present case taxpayer had organized and managed, without compensation, several corporations, but had held no stock interest in any of them. In that case, it would be quite clear that his activities did not comprise a business, but instead were merely a gift. It is only where a taxpayer is himself the principal holder of the corporate equity that there is even a colorable argument for regarding the services which he performs gratis as a "business"; for here at least the ultimate object of the activities is to benefit the taxpayer, albeit only through the medium of his investment interest in an entity which, in the eyes of the law, is a creature apart from him. The fact is, however, that the stockholder who personally performs services for his corporation without demanding recompense is making a contribution to the capital of the enterprise—a contribution not in money, to be sure, but certainly in money's worth. From the standpoint of the corporation, it makes no difference whether the stockholder receives a fee or salary for his services and then contributes that compensation, or whether he contributes the services themselves.[15] In a real sense, the stockholder's investment of services is at the "risk" of the company's business no less than his investment

[15] Of course, if the taxpayer were actually to earn compensation for his services, he would have to pay a tax on the income; and the corporation would be entitled to an equivalent deduction.

of funds might be, for they will yield him no gain unless the corporation turns a profit. It is clear, we submit, that a course of conduct which amounts, in effect, to no more than a contribution to the successful operation of a corporation in which the taxpayer is a stockholder, and which is intended to benefit him solely by enhancing the value of his investment, cannot be deemed a separate business of his own.

There can be no doubt that the taxpayer's services were of this unrequited character. His income tax returns disclosed that Mission Orange neither paid him nor credited him with a promoter's fee, manager's fee, interest, or even salary during any of the years involved here. Nor does the record show that he received (as an independent contractor) any promoter's or manager's fee from any of the other corporations through which he operated. He did, to be sure, receive a few small interest payments from some of the companies (*supra*, p. 9); but as the court properly found, and as we shall show (*infra*, pp. 45–46), these receipts were not significant enough to place him in the money-lending business or, by the same token, in the business of financing corporations. At no time, moreover, did the taxpayer ever sell corporations as his stock-in-trade, through a transaction in which he received ordinary income. On the contrary, in 1951, when the taxpayer sold a group of 12 corporations, he reported the transactions as the sale of capital assets (R. 31). It is significant, moreover, that in his tax returns for 1952 (Ex. 13–M, R. 157) and 1953 (Ex. 20–T, R. 176)—in Schedule C "Profit (Or Loss) From Business Or Profession"—the taxpayer re-

ported himself as being in only one business, the restaurant business. Yet these two years, and the year preceding them, are at the height of the period in which the taxpayer now claims he was in the business of organizing, financing and managing corporations.

There is only one sense in which any of these auxiliary activities can be said to constitute a "business." Although taxpayer did not receive any salary from Mission Orange, he did receive salaries totaling $29,400 and $33,450 during 1952 and 1953, respectively, from some of the construction corporations (R. 26, 155, 175). In turn, the activity of being a salaried officer or employee of a corporation is a "trade or business" within the meaning of the expense and loss provisions of the Revenue Code. See, *e.g., Trent* v. *Commissioner,* 291 F. 2d 669 (C.A. 2); cf. *McDonald* v. *Commissioner,* 323 U.S. 57, 62 n. 3. However, even acknowledging that taxpayer's services as a salaried employee of Whipple Lumber Co., Inc., Dozier-Whipple Construction Co., or Angleton Construction Company, to mention only three, did qualify as separate businesses of his own, it is clear that his loans to Mission Orange bore no proximate relationship, or indeed any relationship whatever, to those businesses. Moreover, even if taxpayer had received a salary from Mission Orange itself, he would have the burden of showing that the advances which resulted in the bad debt loss were primarily for the purpose of protecting his job, rather than of protecting his investment. *Trent* v. *Commissioner, supra.* In any case, taxpayer did not make the con-

tention, either in the Tax Court or in the court of appeals, that he was in the business of being a salaried employee and that the primary reason for his making the loans was to preserve his job. If there be a hint of such a contention in his brief in this Court (Br. 54), it comes too late.

The distinction we have drawn between the situation in which the taxpayer's activities (organizing, financing, and managing) are devoted solely to achieving the successful operation of the corporation and the situation where these activities have a profit-making purpose of their own was recognized by both courts below and served as a basis for their decisions (R. 31, 137). Thus the crux of the Fifth Circuit's decision is contained in the following passage (R. 136-137):

> We think that the Tax Court was amply warranted in finding that there was no evidence in this record, other than the simple fact that taxpayer had used his talents as a building contractor to organize a large number of companies to conduct such building operations, that he was interested in any way in doing any more than enabling these separate corporations to achieve a successful and lucrative operation as corporations. Taxpayer's claim, it seems clear to us, falls within the class of those who fail to recognize the distinction between carrying on one's business through a corporate form, which of course, requires some organizing and financing, and the business of dealing in corporations, which may likewise require some financing arrangements. As stated by the Court of Appeals

> for the Ninth Circuit in *Holz* [*sic*] v. *Commissioner of Internal Revenue*, 256 F. 2d 865, at page 870: "Where the former is the situation, it is hornbook law, and not contested by petitioner, that the corporate entity is the primary debtor and stockholder loans to protect his investment or increase its value do not create a separate business for the stockholders. As the Fifth Circuit recently said in distinguishing the Giblin case, supra, "Petitioner was not engaged in the business of dealing in enterprises." Pokress v. C.I.R. 1956, 234 F. 2d 146, 150 note 12. Nor did the Tax Court, nor do we, find him so engaged here. The finding of the Tax Court is binding upon us unless clearly erroneous. Here it is not."

Taxpayer reads into the Fifth Circuit's decision a broad holding that one who is active in organizing, managing, and financing corporations cannot obtain a business bad debt deduction unless he shows "that he was a *promoter* who had formed the corporations for the *purpose of selling them.*" (Br. 42, 49–53) (emphasis in original). We submit that the decision imposes no such absolute requirement. The essential test, as we have argued, is whether the taxpayer's organizing and financing activities are intended to provide him a separate source of profit independent of that provided by his investment in the corporation, rather than merely a means of enhancing the profitability of that investment. And, as we have shown, *supra*, pp. 28–30, the taxpayer need not be a "dealer in corporations" in order to satisfy this test. We do not construe the decision below as espousing a narrower view. In singling out a dealership in corporations as an example

of a true promotional business, the court of appeals, we think, was merely attempting to explain and distinguish its previous decision in *Giblin* v. *Commissioner*, 227 F. 2d 692 (C.A. 5), upon which taxpayer had strongly relied, and at the same time to reply to the erroneous contention in the taxpayer's court of appeals brief (p. 10) (a contention he also made in the Tax Court) that he was in the business of "dealing in enterprises."

The force of the principles and precedents discussed above is such that no court, so far as we can discover, has ever held that a taxpayer was engaged in a trade or business because of the time, effort and skill which he put into managing a single corporation in order to profit as the holder of its stock. As we now show, the same principles are controlling even when the taxpayer maintains such a connection with several corporations.

*3. The vital distinction between advancing a corporation's business for the purpose of profiting as an investor and carrying on a trade or business is not diminished by the number of corporations in which taxpayer has invested*

The basic point we urge in this brief—*i.e.*, that the contribution of services to a corporate business for the purpose of enhancing the value and productivity of the taxpayer's stock is not a trade or business—is equally applicable whether the services are contributed to one or many corporations. The number of corporate entities organized and managed by the taxpayer cannot be determinative of his "business" or "non-business" status. If the continuous, full-time operation and management of one corporation formed by the taxpayer is not an independent trade or busi-

ness, it is difficult to see why similar activity, divided among several such corporations, should change the result. As stated by the Second Circuit in *Commissioner* v. *Smith*, 203 F. 2d 310, 312:

> Respondent's activities in the case at bar were essentially similar to those of the taxpayer in the Clark [*Burnet* v. *Clark, supra*] case, except that respondent here was interested as an investor, manager, and creditor in a number of business enterprises. But since each of these activities separately does not constitute a business, we cannot see how a combination of them spread over various businesses can alter the result. * * *

See also *Holtz* v. *Commissioner, supra*, 256 F. 2d at 869 (C.A. 9). Indeed, whether a taxpayer conducts all phases of his operation through a single large corporation, or, instead, embodies each phase or enterprise in a discrete corporate entity, is largely a matter of choice, the distinct frequently amounting to little more than a matter of bookkeeping.

The present case is a prime illustration, for it appears that all of the corporations formed by the taxpayer here, save only Mission Orange, were operated out of one office (R. 103; Br. 67). If he had combined all his construction-real estate enterprises under a single corporate roof, there would have been little or no difference in the nature or scope of his activities.[16] It would be wholly anomalous to deny

[16] This is undoubtedly true, *e.g.*, of *Maytag* v. *United States, supra*, and *Campbell* v. *Commissioner, supra*.

business bad-debt treatment to a taxpayer who had made loans to the one large corporation through which he conducted his diverse ventures, yet to grant such treatment to another taxpayer, whose activities might have been identical, merely because he had chosen to conduct them through the media of multiple corporations. Since, as we have demonstrated, the decisions of this Court plainly require the denial of business bad debt treatment in the former case, it follows that a similar result should obtain in the latter.

C. THE LOSS FROM THE NONREPAYMENT OF THE TAXPAYER'S LOANS TO MISSION ORANGE WAS NOT INCURRED IN THE ALLEGED BUSINESS OF LEASING REAL PROPERTY, BOTTLING AND SELLING SOFT DRINKS, OR LENDING MONEY, NOR IN ANY COMBINATIONS OF THESE ALLEGED BUSINESSES

The Commissioner's memorandum acquiescing in the petition for certiorari confined itself to the legal issue discussed in Point B, *supra*. Both in the courts below and in this Court, however, as alternatives to the contention dealt with in Point B, taxpayer named several other activities—leasing real property, bottling and selling soft drinks, and lending money—with which he was associated in one capacity or another during the period in which the subject loans were made. He claims that each of these endeavors amounted to a business separate and distinct from Mission Orange, and that the bad-debt loss here was incurred in the course of it. The Tax Court found as a fact (R. 32–33), however, that taxpayer's activities in two of these lines—marketing beverages and lending money—did not rise to the dignity of a "trade

or business." Furthermore, as we will show, the taxpayer wholly failed to prove that the unrepaid loans to Mission Orange were made in connection with any of the three alleged businesses.

*1. The business of leasing real estate*

Taxpayer maintains (Br. 54–60) that he was personally active in the business of acquiring and leasing real estate, that as part of this activity he constructed and rented to Mission Orange the building it used as its bottling plant, and that the advances to the corporation were made in order to assure the profitability of that lease. Even if it be assumed, however, that the rental of the plant was an incident of the real estate business carried on by the taxpayer as an individual, there is no showing in the record that the bad debt loss was proximately related to that business.

It is hornbook law that a taxpayer claiming the right to a deduction has the burden of proving all elements necessary to qualify him for that deduction. *White* v. *United States,* 305 U.S. 281, 292. Here the taxpayer has fallen far short of meeting that burden. In his testimony below, he never so much as mentioned the lease of the plant as a factor motivating his loans to the corporation. Indeed, the main purport of his testimony was to the contrary, for he asserted that either individually or through a partnership he had made a regular practice of advancing needed funds (chiefly for construction purposes) to the many corporations in which he owned stock, and that his loans to Mission Orange (R. 92, 98–99, 100–

101, 121) reflected this customary practice. Similar allegations appear in his "Statement of the Case" before this Court (Br. 7). It is plain that the evidence of a consistent pattern of contributing operating capital to a variety of corporate enterprises, upon which petitioner places so much emphasis, is at odds with his alternative and unsupported contention that in the case of Mission Orange the purpose of the loans was to protect his position as landlord.

Despite the absence of evidence specifically linking the bad debt loss to the business of leasing the plant, taxpayer urges that since the land and buildings cost him $43,601.70, as compared to the $31,800 he had invested in the stock of the corporation, "it is reasonable to deduce that his advances to Mission Orange Bottling Co. were to a significant degree to help it make his rental business profitable" (Br. 58–59). We need hardly point out that the taxpayer himself was the only person in a position to know whether the loans were prompted "to a significant degree" by the desire to further his interest as lessor, and that inferences and speculations cannot take the place of the straightforward testimony which he was uniquely equipped to provide. But even if this Court were to accept the invitation to "deduce" the purpose of the loans, it would be compelled to the conclusion that "real estate" considerations played little, if any, role in the decision to make the loans.

In the first place, by taxpayer's own reckoning, more than half the advances to the corporation—$69,000 out of a total of nearly $132,000—were made before the bottling plant was even constructed and

during a time when Mission Orange was occupying premises not owned by petitioner (Br. 56). Moreover, approximately $25,000 of this $69,000 represented the unpaid purchase price of the bottling equipment which he transferred to the corporation. To say that these massive loans—a large part of which furnished the corporation with its basic tools—were made in the course of the taxpayer's real estate business is to say that the chief purpose of forming the company was to provide a tenant for the bottling plant petitioner anticipated building—a manifest absurdity. Furthermore, of the roughly $63,000 which the taxpayer loaned the corporation *after* the lease was executed, $48,000 was paid on December 15, 1953, the same day on which the taxpayer, by receiving a transfer of the entire equipment of the corporation, made it impossible for Mission Orange to continue in operation. In our view, this final transaction was not a "loan" at all, but rather a payment in exchange for the equipment. In either case, however, it is quite clear that in making these funds available, taxpayer did not act in his capacity as lessor, since by then it was certain that the tenant would never be in a position either to pay its rent or to repay the debt.

The figures to which we have referred also expose the irrelevance of taxpayer's suggested comparison between the $43,000 outlay for the land and building and the smaller amount which represented his 79% share of the corporate equity. Plainly, the taxpayer's true "investment" in the company as of the date of the lease included not only the cost of the

stock but also the $69,000 which he had contributed in the form of advances and which he could not hope to recoup unless the corporation stopped losing money. Thus, the taxpayer's total investment in the company—taking into account both debt and equity—was more than twice the cost of the real estate. Moreover, whereas the recoverability of the investment in the corporation depended entirely upon the success of Mission Orange itself, there is no showing that the land and building could not have been leased on favorable terms to another tenant, in which case, of course, the additional funds he tied up in Mission Orange would have been available for profitable investment elsewhere. In sum, if the corporation failed, the amount which taxpayer stood to lose in his capacity as investor far surpassed his potential loss as lessor.

By the same token, he stood to gain a great deal more as stockholder than as lessor if the corporation were successful. Under the terms of the ten-year lease, the most the taxpayer could hope to earn from his real estate investment was $6,000 per year, plus one percent of the company's gross sales beginning with the fourth year. It is inconceivable that a landlord who was not also the major stockholder of the tenant would have been prepared to make unsecured, interest-free advances to a risky venture, such as Mission Orange—lending it sums which exceeded by far the investment in the real estate itself—merely for the sake of enabling the tenant to meet its preexisting rental obligation. To be sure, if the corporation had

flourished, the indeterminate component of the rent—one percent of gross sales—might have been substantial. But in that case, the benefits which the taxpayer could expect to derive as stockholder would be many times greater. And, as the record shows, when the corporation failed to earn a profit, taxpayer willingly waived the terms of the lease and demanded no rent at all.

We do not deny that the prospect of collateral benefits in the form of higher and more assured rents may have furnished an added incentive for at least some of the advances. But to establish that a bad debt loss is "incurred in the taxpayer's trade or business," it is not enough to show that the hope of some incidental or derivative business advantage fortified the decision to make the loan. The regulations, echoing the language of the committee reports, *supra*, p. 11, insist that the loss be *proximately* related to the business. To satisfy this condition, we submit, the taxpayer must demonstrate either that the purposes of the business in question were sufficient in themselves to motivate the loan—*i.e.*, that the loan would have been made even if no other considerations had been present—or at least that the business purpose, though not independently sufficient, was the dominant factor. In the present case, neither showing has been made. It is clear that the taxpayer would not have advanced Mission Orange the sums he did—or indeed any sums—if he had merely been the lessor of the plant and not also the stockholder. Conversely, it is nearly certain that he would have made the loans

even if he had been stockholder but not lessor; indeed, as we have pointed out, the lion's share of the advances were actually made prior to the construction of the plant, and while the company was leasing premises from a third party. In any case, however, there can be no doubt that the taxpayer's interest as stockholder was the paramount consideration.[17]

*2. The business of lending money*

The Tax Court found that the lending activities in which taxpayer was engaged in the years 1951–1953 did not constitute a trade or business, and that even if they had, there was no evidence that the advances to Mission Orange were part of that business (R. 29, 32). This finding, we submit, was clearly supported by the record. The interest payments received by the taxpayer during the period 1951–1953, as reported in his tax returns, amounted to an average of less than $2000 per year, *supra*, p. 9. The major portion of this income was derived from loans to construction corporations and partnerships in which taxpayer had an investment, and the Tax Court quite reasonably concluded that the purpose of these loans was to pro-

[17] Taxpayer's reliance on *Maloney v. Spencer*, 212 F. 2d 638 (C.A. 9), where the taxpayer was held to be in the business of leasing property to three corporations organized and controlled by him, is misplaced. There, the Ninth Circuit found the necessary "proximate" relationship between the taxpayer's bad debt loss and his business as lessor in the fact that the advancement of funds by the taxpayer was explicitly required by the terms of the lease. In the present case, by contrast, the taxpayer's lease neither explicitly nor implicitly imposed such an obligation.

tect that investment rather than to generate proceeds for a separate money-lending business. The remaining interest receipts—averaging only $500 per year—were produced chiefly by loans to the taxpayer's partners and fellow shareholders. It is fair to regard advances of this nature and magnitude as nothing more than accommodation loans, rather than transactions incident to a regular money-lending business. It would appear that the taxpayer made other advances from which he received no interest,[18] but if so, the precise extent and character of this lending is not disclosed by the record. And, with respect to his alleged money-lending operation as a whole, taxpayer offered no evidence bearing upon the manner in which the loans were made; the amount of time and attention devoted by him to this activity; why interest was received in some instances and not in others; whether, in those cases where interest was received, it was paid pursuant to a binding commitment or voluntarily tendered; whether he held himself out as a financier and sought to attract borrowers—all factors of significance in distinguishing active engagement in the business of lending money from the mere practice of making accommodation loans or contributions to capital. The Tax Court's finding, therefore, should not be disturbed.

Moreover, even if the taxpayer had been in the money-lending business in 1953, the loans to Mission

[18] Thus, in 1953, taxpayer advanced $30,000 to Angelton Building and Holding Co. (R. 121), one of his seven construction corporations.

Orange were not made, nor the resulting bad-debt loss incurred, in the course of that business. The corporate obligations here were neither secured nor even evidenced in writing; no provision was made for repayment of the principal or for the payment of interest; and, in fact, no interest was ever paid. As the Tax Court aptly observed, without interest there is no profit, and without profit there is no business. *Thacher* v. *Lowe,* 288 Fed. 994 (S.D.N.Y.). Here, moreover, unless the business could be placed on a going basis, the taxpayer had no reasonable expectation of even recovering his principal. It seems inconceivable that a professional money-lender would consider risking funds under these circumstances unless he were also the major stockholder of the corporation and were acting primarily with a view to furthering his interests in that capacity. The Tax Court was well warranted, therefore, in finding that the instant debt was referrable to the taxpayer's stockholder interest and not to any lending business, assuming he was otherwise engaged in one.

The taxpayer (Br. 71) seeks to supply the missing and essential element of profit-motive by invoking Article 5070 of Vernon's Texas Civil Statute, which provides that:

> When no specified rate of interest is agreed upon by the parties, interest at the rate of six per cent per annum shall be allowed on all written contracts ascertaining the sum payable, from and after the time when the sum is due and payable; and on all open accounts, from the first day of January after the same are made.

Under Texas law, it would appear that that provision is inapplicable to obligations of the type created here.[19] But even if it were assumed that the Texas statute imposed an interest obligation as a matter of law, this still would not establish that the taxpayer's informal advances were the actions of a business money-lender, for it would be extraordinary indeed to find a money-lender who would fail to provide in the customary manner for the profit which is the life blood of his whole enterprise, but would be content to rely upon a statute of doubtful applicability to fix the interest rate for him.

*3. The soft drink business*

The Tax Court found that taxpayer was not in the soft drink bottling business at the time the debt in question became worthless (R. 32–33). Taxpayer maintains, however, that he was personally engaged in carrying on an "over-all soft drinks enterprise," only one phase of which—the bottling phase—was con-

[19] The taxpayer's advances were not pursuant to any "written contract." Nor (except perhaps for the $25,000 account payable accrued by the company when it bought the taxpayer's bottling assets) were they loans "on open account," as that term has been defined by the Texas courts. Thus, in *McDaniel* v. *Nat. Steam Laundry Co.*, 112 Texas 54, 58, 244 S.W. 135, dealing with an earlier interest provision, it was held that "open account," within the meaning of the Texas statutes, refers only to transactions in which the relationship of debtor and creditor is created by *the sale and purchase of personal property*. In *Coutourie* v. *Roensch*, 134 S.W. 413, 416–417, the court said that "[m]oney advanced under a contract, or at the instance and request of another, does not constitute an open account within the meaning of article 3102, Rev. St. 1895."

ducted by Mission Orange. His individual participation in this "over-all" enterprise allegedly consisted of holding the bottling franchise, owning and leasing to Mission Orange the bottling plant in Lubbock; organizing and owning 76% of the stock in Mason Root Beer, a soft drink distributing company in Amarillo, Texas; jointly owning a soft drink vending machine business; serving as president of and (after August 1, 1953) plant manager of Mission Orange; supplying funds to the corporations; and, after December 15, 1953, owning the machinery and equipment of the bottling company (Br. 73–75; R. 32). Taxpayer explains that the phrase "soft drink enterprise" is used in his brief in contradistinction to "bottling business," the more restrictive term which the Tax Court used and which, according to taxpayer, accounted for the court's unduly "narrow examination." The Tax Court, however, carefully spelled out the argument which taxpayer makes here, recited in his own words all of the activities which he now alleges to constitute a "soft drink enterprise," and only then found against him. There can be no contention, therefore, that the court's finding rested upon a misunderstanding of the taxpayer's position or a failure "to come to grips with the real issue" (Br. 73).

The finding, moreover, was amply warranted. Although for a short time in 1951 the taxpayer was in the bottling business as a sole proprietor, he transferred his assets to Mission Orange on July 1 of that year and thereafter the bottling enterprise was carried

on solely by the corporation. Similarly, it is difficult to see how Mason Root Beer, another soft drink corporation organized and controlled by the taxpayer, can be considered part of a business conducted by him as an individual. But even if the root beer operation had been carried on by the taxpayer himself, rather than by his corporation, there would still be no evidence that it had any connection with Mission Orange (or any of the other activities alleged to constitute the "over-all soft drink enterprise") other than that the product distributed by Mason in Amarillo was also bottled in the Lubbock plant.

The holding of a soft drink franchise is not itself a business activity; it is merely a precondition to entering the business. Whether the holder is *in* the business depends upon the degree to which he actually undertakes the activities which the franchise allows him to undertake, and this must be determined without reference to the holding of the franchise itself. Nor, of course, did taxpayer become a *soft drink* entrepreneur merely by constructing, owning and leasing to Mission Orange a building to be used as a bottling plant.

There remains only one activity which could possibly qualify as a soft drink enterprise carried on by the taxpayer personally—namely, the vending-machine operation set up as a joint venture with Ideal, Indiana (R. 28, 114). But as to the precise nature and location of this enterprise, and the relationship (if any) which it bore to Mission Orange, the record is almost mute, disclosing only that "we hold [sic]

vending machines to the trade." Whether the business was active or dormant; whether the machines were geared exclusively or even primarily to Mission Orange products; whether the bottled products themselves, or only the machines, were sold to the trade;[20] whether the operation was centered in Indiana (as the name of the joint venturer suggests), in Texas, or elsewhere—these and other important questions are entirely unanswered. Two facts, however, are significant. First, the tax returns for the years 1952 and 1953 disclose that taxpayer received no income in that period from the vending-machine "business" or indeed from *any* of the activities alleged to have constituted a separate individually-conducted soft drink enterprise. This consideration alone would seem fatal to the taxpayer's contention. Second, taxpayer has never claimed, and does not now claim, that the purpose of the advances to Mission Orange was to protect the vending-machine business or assure it a continued supply of bottled products. And there would be no evidentiary support for such a claim even if one were made. Under these circumstances, we submit, the brief reference in the record to "a vending machine set up" (R. 114) is not enough,

[20] In his petition in the Tax Court, the taxpayer stated that the vending-machine operation consisted of "selling Mission Orange Bottling products through vending machines as a joint venture on the side with two employees of the corporation" (R. 7). In his actual testimony, however, taxpayer did not state that the bottling products themselves were sold in connection with the vending-machine operation.

either alone or in conjunction with the other factors we have discussed, to establish an "over-all soft drink enterprise" out of which the bad-debt loss arose.

*4. Combination of activities.*

Having argued that a variety of activities on his part each constituted a business in the course of which the instant loss was suffered, taxpayer makes a scatter-gun claim that the courts below, even if correct in rejecting his contentions as to each individual line of activity, erred in failing to recognize that the combination of these various elements satisfied the statute. In so doing, he merely reiterates the several arguments advanced with respect to the individual claims and fails to show in what way the whole amounts to more than the sum of its parts.

The answer to this contention is apparent from what we have already said. The fact that the taxpayer may have been individually active in a particular business—*i.e.*, construction and real estate—does not transform all his other economic activities—*e.g.*, making accommodation loans—into a trade or business, much less into a single composite business embracing dissimilar and unrelated elements. And even if it did, the fact would still remain that the purpose of the loans and advances which gave rise to the bad-debt loss was not to further the interests of that separate, many-faceted, unincorporated business, but rather to make Mission Orange a successful investment.

## CONCLUSION

For the reasons stated above, the judgment of the United States Court of Appeals for the Fifth Circuit should be affirmed.

Respectfully submitted,

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